

The Worst Place To Litigate Merchant Cash Advance Disputes Is Out-of-State, So Fix Your Contracts Already!

August 18, 2021

By Jacob Nemon and Jeff Boxer. Published in the [*New York Law Journal*](#).

Our [prior article](#) discussed the predictability of litigating usury disputes involving merchant cash advance (MCA) agreements with New York choice-of-law clauses in New York—although we posited things were going to get (a little) wilder. But New York is not the only forum in which MCA customers (referred to as “merchants”) assert usury claims.

Despite New York choice-of-law and venue provisions, MCA funders are often forced to defend the lawfulness of their New York MCA agreements when domesticating judgments or sued by merchants in sister states, or when making claims in bankruptcy courts where merchant debtors are located. Sometimes these proceedings do not go well for funders, but they provide teachable lessons for fixing MCA contracts.

New York Cases Typically Favor MCA Funders, Unless the Contract Is Poorly Drafted. To our count, at least 49 New York decisions have concluded that MCA agreements were purchases of future receivables, not loans, and therefore not subject to New York’s usury laws. An MCA is the purchase of a business’s receivables and, rather than having an absolute right to recover the purchase price, the funder undertakes the risk that the merchant’s business may fail. This holds true even where the funder takes security for the merchant’s performance of the MCA agreement, such as confessions of judgment, security interests and personal guaranties.

Where New York courts did find that MCA agreements were loans disguised as MCAs, it was *usually* because the agreements failed the three-factor test in *LG Funding v. United Senior Props. of Olathe*, 181 A.D.3d 664, 666 (2d Dep’t 2020) (“(1) whether there is a reconciliation provision in the agreement; (2) whether the agreement has a finite term; and (3) whether there is any recourse should the merchant declare bankruptcy.”).

For example, *Advance Servs. Group v. Acadian Props. Austin*, 2021 N.Y. Misc. LEXIS 1138, *13-17 (Kings Co. Sup. Ct. March 12, 2021), granted a merchant’s cross-motion for summary judgment dismissing an MCA collections action for failing the first and third *LG Funding* factors. The reconciliation provision in the agreement—intended to enable the merchant to request that its fixed daily payments more closely estimate a specified percentage of its diminished receivables merely provided that the funder “may ... at its sole discretion” grant reconciliation. Because reconciliation was discretionary, the court held that the funder’s “entitlement to repayment was absolute, rather than contingent, and therefore is indicative of a loan, as a matter of law.”

Furthermore, the agreement provided that the confession of judgment and personal guaranty could be enforced immediately upon a bankruptcy filing, indicating—*improperly* for a true MCA agreement—that a merchant bankruptcy was itself a breach. The court found that in this situation, the agreement’s usury savings clause (which would have reduced the rate of interest to the highest rate under applicable law) violated public policy.

Some Out-of-State Cases Punish MCA Funders With Poorly Drafted Contracts. While New York courts have provided a good indication of what they look for when analyzing MCA agreements, MCA litigation may be trickier when it happens out-of-state or in bankruptcy courts. Granted,

some out-of-state courts dutifully apply New York choice-of-law clauses and dismiss usury claims when raised by out-of-state merchants. See, e.g., *AKF v. Upcountry Servs. of Sharon*, 2020 Conn. Super. LEXIS 221, at *7-9 (Conn. Super. Ct. Feb. 5, 2020) (dismissing merchant's usury defense); *Gecker v. LG Funding (In re Hill)*, 589 B.R. 614, 621-23 (Bankr. N.D. Ill. 2018) (dismissing adversary proceeding to recover alleged fraudulent transfers to MCA funder and disallow funder's claims). However, litigation is not always rosy for funders in foreign forums, despite New York choice-of-law provisions.

In *Cap Call v. Foster (In re Shoot the Moon)*, 2020 Bankr. LEXIS 3157, *9-17 (Bankr. Mo. Nov. 6, 2020), which denied summary judgment to a funder seeking a declaration of its rights to funds in certain of the merchant's accounts, the court found no outcome-determinative difference between Montana law, where the debtor was located, and New York law, and applied Montana law.

In a blow to the funder, the court ruled that the "collective effect" of some of the protections ensuring merchant compliance with the agreement created "an allocation of risk whereby [the funder] is protected by significantly more than just the value of the receivables it purportedly bought" and was likely a loan. These protections included a security interest in all assets of the merchant (not just the sold receivables), a security interest and guaranty for both "payment and performance," a confession of judgment, an assignment of lease in the merchant's real property and a requirement to provide bank statements within five days.

It did not help that correspondence showed the funder itself referring to MCA transactions as "loans" with "terms," and bank statements showed the remittances came from commingled accounts rather than deposits of the merchant's receivables.

Then there are the contrasting decisions issued simultaneously by the same bankruptcy judge in the *GMI Group* bankruptcy, both decided under New York law. In *GMI Grp. v. Reliable Fast Cash*, 2019 Bankr. LEXIS 2494, at *20-33 (Bankr. N.D. Ga. Aug. 9, 2019), the court granted summary judgment dismissing the merchant's adversary proceeding to set aside the MCA agreement.

In addition to ruling that the agreement was not a loan under an *LG Funding*-like analysis, the court rejected the merchant's argument that a provision requiring that the amount of the daily remittance be maintained in the merchant account converts the agreement into a loan, since the provision exempted the merchant from a default if it provided sufficient notice to the funder that it had a low balance as a result of a business slowdown and cooperated in providing financial information to the funder.

In contrast, in *GMI Grp. v. Unique Funding Sols.*, 606 B.R. 467, 487-88 (Bankr. N.D. Ga. Aug. 9, 2019), the court found that a different MCA agreement was a loan because a provision "[r]equiring the debtor to have twice the daily amount in its accounts every day during the duration of the Agreement assures default by the Debtor (and in turn, repayment of the purchased amount)."

The court also ruled that the reconciliation provision, which limited the merchant's right to reconcile to once per month, improperly foreclosed a merchant from obtaining a second reconciliation in a single month of continuing operational downturn.

Finally, the court was bothered by the lack of specificity in the agreement as to when the new daily remittance amount would be effective and whether the merchant would be in breach if it paid less than the previously effective daily amount while the reconciliation request was pending.

In *Saturn Funding v. NRO Bos.*, 2017 Mass. Super. LEXIS 3, at *4 (Feb. 21, 2017), the court refused to enforce a New York judgment by confession against a Massachusetts merchant and guarantor after it was domesticated in Massachusetts, finding the underlying agreement was a loan that violated Massachusetts usury and consumer protection statutes.

Notably, however, the funder apparently did not substantively oppose the merchant's application to vacate, and the court's conclusion was based solely on the numbers on the face of the document, rather than a deep dive into its substantive structuring.

Finally, in an early MCA case, *Essex Partners Ltd. v. Merch. Cash & Capital*, 2011 U.S. Dist. LEXIS 172116, *7-18 (C.D. Cal. Aug. 1, 2011), the court determined that California law should apply, in the absence of a material difference between California and New York law. The court ruled that even where the agreement stipulated that the payment be made by the merchant's credit card processor of a percentage of the plaintiffs' credit card daily receivables—a seemingly *truer* sale because it directly correlates to the ebbs and flows of the merchant's receivables and does not require a manual reconciliation by the funder—the protections afforded by the MCA agreement made it a usurious loan under California law.

Fix Your Contracts Already. Regardless of whether the *Cap Call*, *GMI Group*, *NRO Boston* and *Essex Partners* courts were right on every point—and if we could intervene and appeal, we certainly have a few arguments to make—they stand as stark reminders to MCA funders that their agreements will not always be judged in courts bound by the *LG Funding* precedent. These out-of-state cases provide teachable points for ensuring MCA agreements are structured to avoid even the perception they may be loans. If even one court sees a particular agreement as a loan, then on balance it seems a good idea to revise contracts to address those concerns before another court—even one in New York—seizes on the same issues.

Many of the provisions these courts found to be indicia of loans are identical to some we have seen in legacy MCA forms still being used by some funders. With MCA case law constantly evolving—and in some cases being defined by out-of-state courts—and regulation on the horizon, MCA funders should vigilantly and constantly revise their agreements.

Jacob H. Nemon is an associate and Jeffrey S. Boxer is a partner in the *Litigation and Disputes* department of Carter Ledyard.

Reprinted with permission from the August 18, 2021 edition of the *New York Law Journal* © 2021 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-257-3382 or reprints@alm.com.

related professionals

Jacob H. Nemon / Partner

D 212-238-8728

nemon@clm.com

Jeffrey S. Boxer / Partner

D 212-238-8626

boxer@clm.com